Longevity and reinsurance appetite

Although death is often quoted as one of life's only certainties, the timing is rarely predictable. Managing this uncertainty is a key element of protecting the safety of people's pension.

This "longevity risk"

is one that plan sponsors and trustees are already familiar with – especially in the current low interest rate environment. For most annuity purchase transactions, some longevity risk is transferred to a reinsurer rather than being fully held by the direct insurer.

> *"For all but the largest annuity purchase transactions, the process of implementing a longevity swap will be invisible from the perspective of trustees and sponsors."*

HOW LONGEVITY RISK IS TRANSFERRED?

By far the most common structure uses a bespoke agreement known as a longevity swap which defines payments between the insurer and reinsurer. These payments work as illustrated in the diagram opposite:

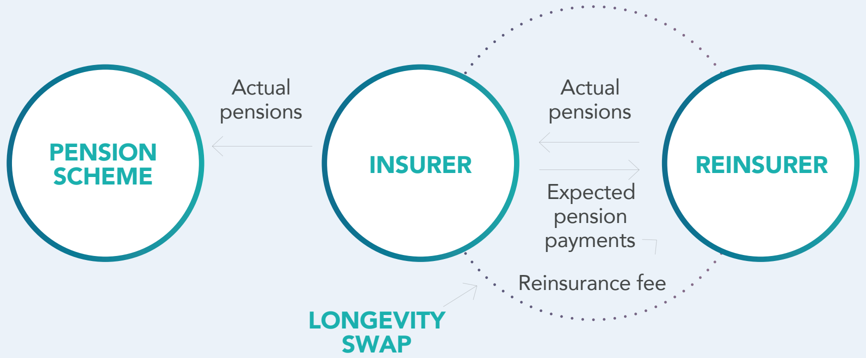
The insurer receives a series of payments that are determined by the actual pensions they pay out. In return, they commit to pay the reinsurer a set of fixed payments that are equal to the expected pension payments at the time of the reinsurance deal, together with a fee payable to the reinsurer. In the unlikely event that people live exactly as long as expected, the only payment exchanged would be the reinsurance fee.

After putting in place a longevity swap, the insurer still needs to invest assets so they can meet the payments to the reinsurer. However, the insurer no longer needs to take the risk that pension payments are higher than expected because people live longer than originally assumed.

TRANSACTION PROCESS FOR LONGEVITY SWAPS

For all but the largest annuity purchase transactions, the process of implementing a longevity swap will be invisible from the perspective of trustees and sponsors.

For smaller transactions (less than £300m), there is sometimes a preferred reinsurer from which the insurer has received guaranteed pricing for future transactions. Alternatively, the insurer may retain longevity risk or bundle together several smaller transactions before approaching the reinsurance market.



For larger transactions, reinsurers are increasingly being asked to provide longevity terms at the same time as the quotation process. This is especially true where schemes have a reasonable level of mortality experience data that can be used to set longevity assumptions, and this can take up to eight weeks to price. Cleansed and complete data allow for quicker quote turnaround and a higher likelihood of having the transaction prioritised in a busy market. From an end-to-end perspective, the longevity transaction has similar steps to an annuity purchase process – future payments need to be priced up, a reasonable fee is determined through a competitive process, internal reviews and approvals are obtained and a reinsurance contract is negotiated.

WHY DO INSURERS TRANSFER LONGEVITY RISK?

This additional work to transfer longevity risk has a number of significant benefits for insurers under the UK regulatory regime:

- *Many are already holding significant longevity risk from earlier transactions and individual annuity portfolios will want to ensure this is balanced within their overall business*
- *It removes the need to hold capital to cover longevity risk (and replaces it with counter party capital) and alleviates some of the Risk Margin strain*
- *Ultimately it increases security for policyholders and shareholders*

Many annuity purchase transactions involve some form of longevity reinsurance for these reasons. Some insurers will pass all longevity risk on immediately, others will be comfortable retaining elements of longevity risk where it provides diversification with other risks they are running in their business.

WHY DO REINSURERS HAVE APPETITE FOR LONGEVITY RISK?

Most reinsurers are governed by the same regulatory regime as insurers so it might seem surprising that taking longevity risk is attractive to them. The key difference for reinsurers is they can hold UK longevity risk alongside other risks written in domestic and overseas markets from both life and non-life reinsurance. This diversification provides a more capitaleff cient home for longevity risk.

Of significance here is the large volume of life insurance policies that are currently reinsured, especially in North America. Holding this "mortality risk" (where claims are paid when people die) provides a significant offset against longevity risk and reinsurers that hold alongside each other can hold less capital as a result. A reinsurer holding just one of these risks would need to charge higher fees to cover the higher capital required. Maintaining an optimal balance of these two risks is one of the key factors that impacts the reinsurance pricing of longevity risk.

HOW MUCH REINSURER APPETITE IS THERE FOR LONGEVITY RISK?

At present there is significantly more mortality risk within the global reinsurance sector than longevity risk. Many countries have primarily relied on the state sector to provide pension, so longevity risk largely sits with future generations of tax-payers. However, the market for insured longevity risk is currently growing far quicker than for mortality risk and at some point, the optimal diversification between the two will be reached. Although not immediately a constraint, this strong relative growth in longevity risk may impact pricing in the medium term.

Despite this, reinsurance appetite for UK longevity risk is likely to remain strong in the near term. One of the key constraints at present being simply having enough people within the organisation to keep up with demand. A key threat to near term capacity is the emergence of other markets for longevity risk transfer (such as the US or Canada) which may start to take up more attention given the closer offset to many reinsurers' large mortality portfolios written in North America.

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